NEW AMERICA FOUNDATION

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To: Grant Boyken, California Secure Choice Retirement Savings Program
From: Michael Calabrese, Senior Research Fellow; Reid Cramer, Director; and Aleta Sprague, Policy Analyst, Asset Building Program, New America Foundation
Re: Secure Choice RFI #13-01

Introduction

The Asset Building Program at the New America Foundation incubates promising policy proposals and serves as a leading voice on innovative public policies to enable low- and middle-income families to accumulate savings, access wealth-building financial services, develop financial capability, and build and protect productive assets across the life course. The mission of the Asset Building Program is to significantly broaden access to economic resources through increased savings and asset ownership, thereby providing families with enhanced economic security, a direct stake in the commonwealth, and the means to pursue their aspirations.

Increasing access to retirement savings opportunities and incentives for low- and moderate-income workers is a cornerstone of our policy agenda. Earlier this year, we published an issue brief about the California Secure Choice Retirement Savings Program (attached as an appendix to these comments), which outlined its key features, offered some additional design considerations, and highlighted its potential to set an important precedent for similar state initiatives throughout the country. In the past, we have published papers and provided testimony about automatic IRAs, universal 401(k)s, and the role of the tax code in creating inequitable subsidies for retirement savings, as well as the potential for tax reform. Drawing upon this work and our expertise, this note responds to a Request for Information issued by the California Secure Choice Retirement Savings Investment Board.

Plan Structure

Question 1: What type of plan structure would you recommend to best meet the statutory goals and objectives for the Program, which include simplicity, ease of administration for employers, preservation of principal and portability of benefits (e.g., a pooled fund with guaranteed interest credited to individual accounts on a regular basis that utilizes a gain and loss reserve? Individually held IRA-type accounts with a variety of funds from which participants could choose? Something else altogether?)

Secure Choice presents some unique challenges for structure and administration due to both its ambitious size and the likelihood that many enrollees' accounts will have a low balance (at least initially). To keep costs low and promote efficiency, the program should leverage economies of scale by pooling workers' contributions, select a single plan with limited investment options, and contract for professional investment management of the collective funds, as envisioned by SB 1234. Furthermore, to preserve portability and create effective "career accounts," a central clearinghouse should receive the payroll deposits and maintain at least a notional account for every worker in the system.

In a traditional 401(k), an employer chooses among IRA providers on behalf of its employees. There are several reasons why this model would not be advantageous for Secure Choice.

First, it would significantly hamper the program's objective of portability. Accounts that are tied to an employer, rather than managed through a centralized structure, are more vulnerable to "leakage" and abandonment, and typically have higher transaction costs. Australia provides a telling example. While Australia's unique retirement system has been very effective due to automatic, required contributions, its industry-based structure has diminished its success: as of 2008, there were 6.4 million lost or abandoned accounts with nearly $13 billion held by financial institutions.[1] Consequently, in 2011, Australia implemented a reform to streamline account reporting through a central clearinghouse that will track each worker's accounts by Tax File Number (equivalent to a U.S. Social Security number). This reform should also reduce leakage; assets that accumulate automatically from one job to another through a clearinghouse mechanism would be less susceptible to withdrawals during a career change.

Second, an employer-based structure could result in an inequitable market segmentation, as the larger, lower-cost mutual fund complexes focus on marketing to primarily larger employers with above-average wage workers. These will be the more profitable accounts and will tend to have a lower cost structure as a percentage of assets under management.

Instead, the Secure Choice Investment Board should select a single plan provider (similar to the model used by the Federal Thrift Savings Plan and TIAA-CREF, discussed below) and contract out investment management to a private financial institution. Selecting only one provider will allow for the greatest economies of scale, maximizing group purchasing power and minimizing administrative costs. However, if the Board determines that there should be a choice among competing private IRA providers, that choice should be made by the individual worker rather than the employer. After all, the worker's participation in Secure Choice is premised on the fact that their employer chose not to sponsor a retirement plan. Furthermore, since an employer would not be liable for the plan's performance, its due diligence in selecting a provider – and even its motivations – could be suspect, such as basing it on personal relationships or other quid pro quos that could be outlawed but nearly impossible to identify or enforce in this context.

Furthermore, any choice among providers should ideally become available only after a worker's account has reached an asset level that makes it profitable to a private firm. At that point the individual can decide to roll all – or a portion – of assets to a qualified Secure Choice provider, and Secure Choice could maintain an investment clearinghouse for that purpose. Regardless, the same streamlined, low-cost model should be a condition for any Secure Choice IRA provider. This would prevent providers from competing on the basis of offering more exotic or expensive investment options that would actually be a disservice to the vast majority of workers, who also are unlikely to understand the true risk profiles and cost-benefit trade-offs.

Turning to investment options, to maintain simplicity and ease of administration, enrollees should have a choice among only a limited number of funds. Restricting these choices to those contracted through the state will also support portability, since a worker's account and investment options will not change as they move from one employer to the next.

The Thrift Savings Program (TSP), the retirement savings program for federal employees, should be closely examined as a useful model. The experience of the TSP is an appropriate reference model because it currently manages accounts for over 4.3 million active and retired federal employees and has a similar set of services as would be required by Secure Choice. The economies of scale that the TSP has achieved help it keep its administrative costs low. Additional factors in minimizing administrative costs include providing relatively restricted access to the account and account information, limiting investment options, and restricting the ability to change investment choices compared to private sector mutual fund companies. The size of the overall investment pool has enabled the TSP to negotiate a low investment management fee with its private sector investment manager compared to other types of accounts.[2]

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[1] Calabrese, Michael (2011). "Facing Up to the Retirement Savings Deficit: From 401(k)s to Universal and Automatic Accounts." New America Foundation.
[2] Cramer, Reid (2006). "Net Worth at Birth: Creating a National System for Saving and Asset Building with Children's Savings Accounts." New America Foundation.

Participants in the TSP can choose among a short list of funds, ranging from the "G" Fund, which invests solely in government securities and guarantees the principal, to the "I" Fund, which invests in a range of international stocks and carries the greatest degree of risk.[3] Average annual returns for the G Fund have been 3.6% over the previous ten years, compared to 8.4% in the I Fund. Including an option for a guaranteed return, either secured by private insurance or similar to the TSP's "G" fund, would fulfill Secure Choice's objective of safeguarding the principal. However, the additional choices would give workers the option of potentially increasing their returns or better matching their risk-reward profiles. Importantly, these options should be accompanied by adequate information and education regarding the varying levels of risk that come from increased market exposure.

A similar model that may be examined in the study is TIAA-CREF, the college and non-profit education retirement fund system. Consistent with the objectives of SB 1234, CREF was developed to provide retirement account portability and pooled professional asset management for college professors and other personnel as they moved between jobs. Although the TSP's more simplified range of investment choice seems most appropriate for Secure Choice, at least initially, CREF provides another successful example of a relatively low-cost means of ensuring "career account" portability to workers even as they move between employers.

Investment Options

One of the shortcomings of the shift from defined benefit plans to defined contributions plans is that the responsibility for all investment decisions has fallen to individual workers, most of whom lack the professional financial expertise to effectively navigate the complex set of choices required. This feature exposes many workers to undue risk and makes it more difficult to build an adequate savings balance. A better system would establish appropriate default features, derived from principles of behavioral economics, that would set workers up for success even if they take no action. These features include automatic enrollment into an appropriate fund, automatic escalation of contributions, and distribution options that encourage a lifetime stream of income.

Question 3: If you recommend more than one investment option, what would you recommend as the "default," or automatic, option that would be chosen for participants who do not make an affirmative decision?

If Secure Choice participants have a range of investment options, the default should be a life-cycle/Target Date fund, or any option that similarly maintains an age-appropriate allocation of equities and fixed-income investments at low cost (e.g., via market index funds). More specifically, index funds or exchange-traded funds (ETFs), most of which are passively managed, have several advantages over actively managed funds that would enable Secure Choice to limit costs and promote efficiency. Compared to traditional mutual funds, ETFs generally have low annual fees as a result of the lower costs entailed by passive investing and these low fees can yield significantly higher balances for investors.

Question 4: Would you recommend including any insured interest or insured income products? Why or why not? What are the advantages and disadvantages of these products in terms of performance, risks, cost and transparency?

A unique feature of Secure Choice as envisioned by SB 1234 is its provision of a guaranteed return. The goal of this feature is to ensure that workers' retirement security is not put at risk by the timing of macroeconomic shifts. The recession underscored the fragility of 401(k) balances, though many have now recovered to pre-recession levels. However, for those workers who were nearing retirement when the economic crisis hit, the damage to their retirement accounts will have much more lasting consequences.

Indeed, though protecting the principle is always a valid concern, it is particularly important for older workers. The greatest risk of permanent loss in a defined contribution plan is taking a lump sum payout during or after a downturn in the market cycle. For younger workers, it may not be worth the cost to guarantee a positive investment return on a year-in,

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[3] Thrift Savings Plan, Fund Comparison Matrix.

year-out basis.[4] The appropriate "risk" to insure against is a large loss close to retirement. The feasibility study should thus explore guarantees that could effectively (a) protect at least nominal principle, and (b) "smooth" returns over the final years before the target retirement age.

Question 5: Would you recommend the Program provide a lifelong stream of guaranteed income? If so, how would you convert retirement savings into a lifelong retirement income stream, and what investment product would you recommend to accomplish this objective?

As life expectancy rises and Americans are spending more years in retirement, it's increasingly important that their retirement savings are designed to last. A recent survey from the Society of Actuaries found that more than half of respondents, all retirees or near-retirees, underestimated their life expectancy.[5] At the same time, many Americans underestimate how much they will need saved up to maintain their quality of life in retirement.

However, despite these risks, annuities that guarantee consistent payments throughout retirement remain unpopular among retirees. The Retirement Security Project ("RSP"), an initiative of the Brookings Institution, has found that retirees are especially reluctant to choose annuitization where it is presented as a momentous "all or nothing" or "now or never" decision.[6] Consequently, simply establishing annuitization as the default method of distribution is not a comprehensive or sufficiently effective solution to longevity risk. For example, in cash balance plans, despite a legal obligation to establish a lifetime annuity as the default, the "vast majority" of participants opt out to receive a lump sum instead.[7]

In light of these findings, a combination of a trial annuity and partial annuitization may be the most promising default option.[8] This arrangement would give any retiree who does not opt out a familiarity with fixed monthly income payments without locking them in. RSP has proposed that a substantial portion of assets in 401(k)-type plans "be automatically directed (defaulted) into a two-year trial income product when retirees take distributions from their plan, unless they affirmatively choose not to participate." At the end of the trial period, retirees could choose among several options—including opting for a lump sum, or annuitization of all or just a portion of their nest egg. If they made no choice they would default into a permanent income distribution plan. "This would put inertia to work on behalf of the income stream rather than on behalf of the lump sum," according to the RSP proposal. A similar trial annuity could be the default option for Secure Choice assets as well, giving individuals who did not opt out the longevity insurance traditionally associated with a defined benefit plan.

Plan Design and Features

Many of the workers Secure Choice seeks to reach are in low-wage jobs; only 22% of California's workers in the lowest income quartile currently have access to a workplace retirement plan.[9] Designing a retirement savings plan for lower-income workers requires a careful calibration between enabling these workers to accumulate adequate savings for the future and allowing them to maintain sufficient liquidity in the present.

One of the shortcomings of the current defined contribution model is the high rate of early withdrawals, which has been exacerbated by the recession and is particularly prevalent among lower-income households. A recent study from Hello Wallet found that more than one in four American workers with a defined contribution retirement account has used it to

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[4] For an analysis of the feasibility of a guaranteed return backed by private insurance, *see* Rhee, Nari and David M. Stubbs (August 2012). "Can a Publicly Sponsored Retirement Plan for Private Sector Workers Guarantee Benefits at No Risk to the State?" U.C. Berkeley Center for Labor Research and Education.
[5] Society of Actuaries (2012). "2011 Risks and Process of Retirement Survey Report."
[6] Iwry, J. Mark and John A. Turner (2009). "Automatic Annuitization: New Behavioral Strategies for Expanding Lifetime Income in 401(k)s." The Retirement Security Project.
[7] Iwry and Turner (2009).
[8] Calabrese (2011).
[9] Rhee, Nari (2012). "6.3 Million Private Sector Workers in California Lack Access to a Retirement Plan on the Job." U.C. Berkeley Center for Labor Research and Education.

pay for current expenses, incurring significant fees and tax penalties in the process.[10] Lower-income workers are particularly at risk; according to the study, 30 percent of households earning less than $50,000 a year had cashed out a retirement plan for purposes like paying a mortgage or credit card debt. Meanwhile, 26 percent of U.S. households were considered "asset poor" in 2010, meaning they lacked sufficient resources to live at the poverty level for three months in the absence of income.[11]

To avoid these pitfalls, Secure Choice should prioritize both establishing appropriate defaults for retirement deferrals and, if possible, simultaneously supporting workers' shorter-term savings, whether as part of the initial rollout or as a future addition. This could take the form of a non-tax-qualified "sidecar account" (described further under Question 11 below) that gives workers the same advantages of automatic payroll withholding, and pooled, low-cost, professional investment management.

Secure Choice should also provide for voluntary employer contributions to support workers in developing adequate savings and recalibrate retirement security as a shared rather than strictly individual responsibility. If employer contributions are permitted and can be accommodated in a manner that does not create an ERISA plan, then Secure Choice should require that any contributions be made either as a flat dollar amount, or as an equal percentage of wage income, for every employee who is eligible and does not opt out of Secure Choice. This requirement would preempt employer discretion to contribute at different rates for different classes of employees.

Question 8: What would you recommend as the automatic, or "default," contribution level for participants who do not opt out, but who do not make an affirmative decision to contribute at a higher rate than the default rate?

In 2012, the average employee contribution to a 401(k) was 6.7 percent of pay, though 53 percent contributed 5 percent or less.[12] A survey of Vanguard's DC plans in 2013 revealed that 68 percent of workplace plans with automatic enrollment chose a default contribution rate of 3 percent or below, while only 12 percent selected 6 percent or more.[13] Some researchers attribute lower average contribution rates in recent years to the popularity of automatic enrollment, which has increased participation, but often sets artificially low default deferral rates.

If we intend the "default" rate to be interpreted by participants as expert advice about smart savings behavior, then a 6 percent default rate would seem minimal. Most retirement experts recommend eventually saving between 12 to 15 percent of income (including employer contributions) to achieve adequate retirement savings. Furthermore, at least one study has shown that increasing the default contribution rate from 3 percent to 6 percent has a negligible impact on participation (though it should be noted that this model assumed employer contributions as an incentive).[14] Finally, it's worth noting that automatically escalating to a higher default contribution rate would have little if any downside since a participant can always choose to reduce their contribution rate to 3 percent or below if the default threshold is higher.

However, the study that found no participation difference between 3 percent and 6 percent contributions did not take into account participants' income. Furthermore, even if the impact of this increase on participation is minimal, for those participants with especially low incomes, it is important to keep in mind the impact on liquidity and ability to pay for everyday expenses. Finally, a low initial default is less problematic if there is a strong automatic escalation policy in place, as discussed in the next question. Given these constraints and considerations, maintaining a 3 to 4 percent default

[10] Fellowes, Matt and Katy Willemin (2012). "The Retirement Breach in Defined Contribution Plans: Sizes, Causes and Solutions." Hello Wallet.
[11] Corporation for Enterprise Development (2012). "Assets and Opportunity Scorecard."
[12] Copeland, Craig (2013). "Retirement Plan Participation: Survey of Income and Program Participation (SIPP) Data, 2012." Employee Benefit Research Institute.
[13] Vanguard, "How America Saves 2013."
[14] Beshears, et al (2006). "The Importance of Default Options for Retirement Savings Outcomes: Evidence from the United States." National Bureau of Economic Research, Working Paper 12009.

contribution rate, coupled with automatic escalation, may be the ideal default for supporting participants' savings accumulation while being mindful of their other financial needs.

Question 9: What options, if any, would you recommend for an automatic escalation feature that increases participants' contributions over time?

Automatic escalation is a very important feature for ensuring that workers accumulate sufficient balances by retirement. While automatic enrollment takes advantage of inertia for workers' benefit, inertia can weigh against these same workers if there is no mechanism to increase their contributions over time. As noted, most plans begin with default deferrals of 3% at most; if unchanged over time, this contribution level will be insufficient to adequately replace income at retirement. Meanwhile, a 2007 study from the Employee Benefit Research Institute (EBRI) found that automatic escalation would likely increase overall 401(k) accumulations between 11 and 28 percent for participants in the lowest-income quartile.[15]

There are three design questions that are foundational to an automatic escalation policy: how often contributions should be increased, by how much, and until when. A 2010 study from EBRI found that the probability that a worker in the lowest income quartile will achieve a combined income replacement rate of at least 80 percent increases from 46 percent to 79 percent where four factors are present: 1) maximum employee contributions are increased from 6 percent to 15 percent; 2) the annual increase in contributions is 2 percent rather than 1 percent; 3) the employee does not opt out of automatic escalation; and 4) the employee maintains his previous contribution level when moving from one job to the next.[16] The report also isolates the effects of each factor on the probability of attaining the 80 percent replacement rate measure of success. Increasing the limit on employee contributions to 15 percent has by far the greatest effect, and boosts the likelihood of success for those in the lowest income quintile by 16.4 percent. Increasing the rate of escalation from 1 percent to 2 percent only boosts likelihood of success by 1.3 percent.

These findings would suggest, first, that establishing automatic enrollment and enabling a generous maximum employee contribution should be a priority for Secure Choice. The feasibility study should further evaluate what precise maximum threshold would help lower-income workers accumulate sufficient savings without deterring participation. These maximum savings levels, however, could likely exceed the current IRA contribution limits for many workers (in 2013, \$5500 or \$6500 for those over age 60), which appear to be the limits envisioned by SB 1234.[17]

Second, the difference between a 1 percent or 2 percent annual increase appears to be of less consequence. Given the low incomes of many of the Californians Secure Choice is designed to reach, a yearly increase of 1 percent may be the better option for helping workers gradually increase their savings without counterproductive restrictions on liquidity or significant long-term consequences for accumulation. Alternatively, it may even be worth considering a half percent yearly increase, particularly for some of the youngest participants who have more time to develop an adequate balance. A 1 percent increase would mirror the policies of approximately two-thirds of the DC plans that currently feature automatic escalation.

Finally, some retirement plans have an automatic escalation policy that increases with each pay raise, rather than necessarily each year. From an administrative simplicity perspective, it would likely be easier to increase all participants' contributions on an annual basis up to a maximum percentage deemed unlikely to push workers to opt out completely.

Question 10: Are there any other plan design features that should be included (or eliminated) to ensure the plan meets the goals and objectives of the Program? Please explain.

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[15] VanDerhei, Jack L. (2007). "The Expected Impact of Automatic Escalation of 401(k) Contributions on Retirement Income." Employee Benefit Research Institute, Notes Vol. 28, No. 9.
[16] VanDerhei, Jack and Lori Lucas (2010). "The Impact of Auto-enrollment and Automatic Contribution Escalation on Retirement Income Adequacy." Employee Benefit Research Institute, Issue Brief No. 349.
[17] The California Secure Choice Retirement Act, Title 21, Sec. 100010 (a) (11).

Although Secure Choice as envisioned would enable the vast majority of private employees to qualify for the plan, some are left out. In particular, workers employed by the smallest firms, as well as those who are self-employed, may have more difficulty accessing the program because their workplaces are not required to participate.[18] Importantly, the group most likely to be self-employed is men aged 55-64, who are rapidly nearing retirement.[19] SB 1234 provides the Investment Board with the authority to develop procedures for enrolling these workers in the plan.[20] Implementing these policies and assessing how to educate these lower-access workers about their eligibility and the benefits of participation will be of particular importance, since they will not benefit from the same default enrollment mechanism as employees at larger firms.

For example, in lieu of automatic payroll deduction, Secure Choice should at a minimum facilitate automatic monthly (or bimonthly) contributions by automatic bank account debit. Secure Choice could also request that the state facilitate contributions as an add-on to quarterly tax filings by the self-employed – or by anyone with self-employment income.

Similarly, maintaining at least a notional account for every individual who is ever enrolled, by Social Security or Individual Taxpayer Identification Number (ITIN), would further support workers who spend some portion of their working lives self-employed or engaging in contract work. Even if a worker initially enters Secure Choice as a payroll employee, upon moving to an independent work arrangement, they will have an account already established where contributions can flow – and without the need to transfer it from a former employer's financial institution to Secure Choice.

Question 11: What plan design elements would you recommend to minimize pre-retirement "leakage"?

As noted above, many workers who are currently taking loans or withdrawals from their retirement accounts are doing so to pay for current or ongoing expenses. Establishing hardship criteria for taking withdrawals is an important practice for deterring this type of "leakage" if workers have other options. Some 401(k) and 403(b) plans only permit pre-retirement withdrawals in cases of severe financial distress, and subject these so-called "hardship withdrawals" to both income taxes and a 10% penalty. These plans often offer loans, however; as of 2010, 13% of workers with a defined contribution plan had an outstanding loan.[21] Current IRA rules, by contrast, do not allow loans, but also do not restrict withdrawals at any time. However, pre-retirement withdrawals are subject to the same 10% tax penalty unless they are made for a limited number of productive or hardship-oriented purposes.[22]

Restrictions modeled on the current IRA rules may be an appropriate structure for Secure Choice. The IRA rules deter early withdrawals and ban loans altogether, but do not subject workers to the additional 10% penalty if they are facing a true financial crisis. Furthermore, following the IRA rules would reinforce that Secure Choice is not an ERISA plan. However, hardship provisions alone are insufficient. Without some mechanism to support shorter-term, flexible use savings by these workers, it is virtually inevitable that high rates of withdrawals will persist (and/or some workers will opt out of the program due to concerns about meeting their more immediate needs).

It is worth considering how the momentum behind Secure Choice could be used to simultaneously support shorter-term savings. Two existing proposals offer examples of how such a mechanism could operate. First, New America has previously written about a pilot program called AutoSave, through which employers automatically divert a small portion of workers' post-tax earnings into a flexible use savings account.[23] This initiative provides an example of how the same

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[18] *See* Calabrese (2011) for a discussion of how inadequate access by self-employed, part-time and small firm workers is a recurring issue in Auto-IRA proposals.
[19] Schultz, Ellen E., "401(k)s for the Self-Employed." The Wall Street Journal, August 13, 2012.
[20] The California Secure Choice Retirement Act, Title 21, Sec 100012 (l).
[21] Fellowes (2012).
[22] 26 USC §72(t)(2).
[23] Lopez-Fernandini, Alejandra and Caroline Schultz (2010). "Automating Savings in the Workplace: Insights from the AutoSave Pilot." New America Foundation.

payroll deduction process can facilitate a non-retirement sidecar savings account with few if any restrictions on withdrawals. AutoSave is predicated on three principles: 1) working households require non-restricted savings accounts to cover unanticipated expenses; 2) as in the retirement context, instituting an appropriate default will improve savings; and 3) employers are uniquely positioned to facilitate a savings mechanism due to their existing infrastructure (i.e. direct deposit and payroll deductions). Though AutoSave has yet to move past the pilot phase, initial evaluations offer some important considerations for how to design a short-term savings structure that could align with an initiative like Secure Choice.

Second, in the UK, "corporate platform" accounts "allo[w] employees to use the employer's retirement savings mechanism to save and invest for additional nonretirement purposes."[24] Beyond facilitating emergency and short-term savings, this arrangement increases efficiency and enables workers to access an overview of their entire financial status in one place. Moreover, the platform can be customized for individual workers based on age and income, and coupled with financial literacy trainings provided through a range of technologies and communication methods.

These two examples demonstrate how employers can use a singular infrastructure to recognize and support workers' range of savings needs, thus increasing their financial stability and making it more likely they can preserve their retirement savings for retirement.

Costs and Fees

At least initially, Secure Choice should receive and invest all contributions by participating individuals, much as TSP does, by contracting investment management out to private financial firms on a bid basis. This pooled approach, by quickly achieving scale economies, ensures that fees are low and uniform, whether workers are able to save a little or a lot. This approach is particularly critical for low-dollar accounts, such as those of young people and low-income workers, which effectively need to be cross-subsidized until they reach a certain asset level. The feasibility analysis should assess whether – once an account reaches a certain size – the individual workers can choose to roll out all or a portion of the assets to another qualified and competing Secure Choice IRA provider. Secure Choice could maintain a clearinghouse, or exchange, of standardized information on these choices. Secure Choice should also continue to maintain at least a notional account on behalf of each participant that records contributions forwarded to these IRA providers and, if feasible, quarterly or at least year-end allocations and balances for each participant, data that would be reported back by participating providers.

Question 14: How would you recommend the Board ensure transparency of fee and expense information available to the Board and Secure Choice participants including transparency of service providers' relationships or potential conflicts that may increase costs and/or conflict with the interests of plan participants?

Consistent Secure Choice standards should be enforced across all providers, including those that participate in the proposed clearinghouse. These standards should include the calculation of fees as a flat percentage of assets, regardless of overall account size. This fee ratio could vary based on asset allocation category (e.g., a stock index fund could be higher than a government bond or short-term fixed-income fund), but Secure Choice will want to avoid a situation where low-asset accounts pay a higher fee as a percentage of assets – and therefore yield a lower average return on investment, net of expenses, than high-asset accounts. Additionally, at minimum, all fees should be disclosed to the public online in a simple, standardized format.

[24] John, David C. (2012). "Improving All Types of Saving With the UK's Expanded Retirement Savings Platform." Retirement Security Project.

Establishing a Retirement Investments Clearinghouse

A retirement investments clearinghouse could provide workers who have developed a significant balance an informed option to roll over their accounts to a different IRA provider. By requiring or encouraging a specified minimum level of assets before workers can make this choice, Secure Choice would ensure that sufficient assets remain under collective management to achieve economies of scale and keep costs low. Again, as emphasized in response to Question 1, this choice among IRA providers should only be available to workers rather than their employers. The employer's burden can be minimized best by requiring that all contributions be forwarded initially to the central Secure Choice clearinghouse and redirected from there to the default account or outside account selected by workers. This both minimizes costs and provides seamless, career-long portability and choice for individual workers.

Developing the RFP for the market research, plan design and feasibility study

Question 22: Do you have any recommendations for the type of firm, or firms, that would be most qualified and able to conduct the work necessary for the market research, feasibility and plan design study?

Our recommendation would be to enlist both a non-financial industry consulting firm and a California institution of higher learning with pension and retirement security expertise to conduct the market research and feasibility study. This combination of academic rigor with practical market and management analysis would be ideal for developing objective and thorough recommendations for Secure Choice.

Appendix

Asset Building Program

The California Secure Choice Retirement Savings Program:

An Innovative Response to the Coming Retirement Security Crisis

Aleta Sprague

April 2013

Until recently, the "three-legged stool" was the reigning metaphor for achieving retirement security. Workers could anticipate being supported as they aged by a combination of Social Security benefits, private pension income, and personal savings. This model no longer holds. Traditional pensions have almost disappeared from the private workforce, personal savings are low, and Social Security benefits face political and actuarial threats. The new model relies on defined contribution ("DC") plans like the 401(k). Unlike yesterday's pensions, also known as defined benefit ("DB") plans, which based monthly benefits for life on earnings and time served, DC plans derive their value from employee and employer contributions, which are governed by a set of tax rules and limits.

Unfortunately, roughly half the private workforce does not have access to these DC plans because their employers choose not to offer one. Still, for many with access, their accumulated assets will not adequately replace their incomes. Without policy changes, the transition to a 401(k)-based system is on its way to becoming a "failed social experiment."[25]

The state of California has recently embarked on crafting a response. In September 2012, the state legislature passed Senate Bill 1234, which created the California Secure Choice Retirement Savings Program. California Secure Choice ("CSC") would establish automatic retirement accounts for all workers in the private sector who do not otherwise have access to a workplace retirement plan. The program is aimed at reducing disparities in retirement saving and shoring up the three-legged stool.

This issue brief will first, explore the inequities and shortcomings of the current retirement system; second, outline the effort in California to reduce these inequities through universal accounts; and third, offer additional policy considerations for both the California initiative and the national retirement savings framework.

America's Retirement Savings Crisis

A growing number of workers are finding themselves approaching retirement with little— if any—savings to rely on. The statistics are sobering. In 2010, the median household retirement account balance for workers between

[25] Ghilarducci (2008).

the ages of 55 to 64 was a mere $120,000.[26] Converted to a monthly annuity, a worker who retires at 64 with this amount saved up will have access to only $625 per month in supplemental income if he or she lives to be 80. Three-quarters of near retirees (ages 50 to 64) have annual incomes below $52,201 and average total retirement savings of $26,395.[27] Compounding the problem further is the reality that many mid-career workers are not saving at all. A 2012 study found that a third of Americans between 45 and 54 had saved nothing specifically for retirement.[28] As many workers now spend twenty years or more in retirement due to increased longevity, and with workers with the most physically demanding jobs often forced to retire earlier, the financial security of older Americans is in serious jeopardy.

> Without policy changes, the transition to a 401(k)-based system is on its way to becoming a "failed social experiment."

The marked shift over the past three decades from traditional pensions to DC plans like the 401(k) has been a significant driver of this trend. Whereas DC plans originated as a supplement to DB plans, today they predominate as the sole option for many covered workers. From 1980 to 2008, the percentage of private sector workers participating in a DB plan fell from 38% to 20%.[29] During this same period, the proportion of private employees participating exclusively in a DC plan (that is, not in both a DC plan and a DB plan) grew from 8% to 31%. The replacement of DB plans with DC plans reflects a changing conception of retirement security as an individual rather than collective responsibility.

Perhaps it should be unsurprising, then, that many workers find themselves without access to a workplace retirement plan whatsoever. The same proportion of workers guaranteed a traditional pension in 1960 is offered a plan of any kind today (with DC plans the far more likely option); indeed, only 58% of full-time, full-year private sector workers ages 25-64 work for an employer that sponsors a retirement plan of any sort (regardless of whether they are actually eligible to participate).[30] Particularly given the recent increase in part-time work, which is not even encompassed by this statistic, the low rate of access to a retirement plan in the private sector is troubling.[31]

> A 2012 study found that a third of Americans between 45 and 54 had saved nothing specifically for retirement.

A key distinction between DB and DC plans is the allocation of risk. In DB plans, the employer makes all the investment decisions and is accountable for paying the worker's pension regardless of how these investments fare. Pension benefits are inaccessible until the worker reaches retirement, at which point they are generally distributed in equal monthly payments, thus guaranteeing that the worker will not outlive her savings. In contrast to DB plans, with 401(k)s, it is up to each worker to manage his investments and there is no recourse if they lose value. Though these workers can purchase annuities to receive consistent retirement funds for the remainder of their lives, this does not happen automatically and most opt to receive a lump sum. A recent survey, for example, found that only 6.5% of workers nearing retirement having only a DC plan were expecting to receive any portion of their savings as an annuity.[32] By contrast, 92.5% of those with only a DB plan were anticipating a steady monthly payment. Even though annuities are not simple financial products, they do offer

[26] Munnell (2012). This figure represents the median 401(k)/ IRA balance for households in this age group.
[27] Saad-Lessler & Ghilarducci (2012).
[28] EBRI (2012).
[29] Butrica (2009).
[30] Ghilarducci (2008); Munnell et al. (2012).
[31] Rampell (2013).
[32] Watson Wyatt (2008).

benefits in the form of predictable income during the post-work years.

DB plans are not without their problems. Firms can go bankrupt or run into serious financial distress and renege on their commitments. The federally-backed Pension Benefit Guaranty Corporation (PBGC), created in 1974, offers protection for DB plans by providing insurance and assuming the obligations of plans that fail, up to a guaranteed cap per worker. In the early 2000s, due to both macroeconomic factors and companies' underfunding, several large employers defaulted on their pensions and retirees received inadequate settlements, calling into question the terms of the PBGC insurance mechanism. Some argue that certain requirements established by the Pension Protection Act of 2006, while designed to strengthen pension stability in response to these defaults, are in fact deterring companies from maintaining DB plans. At the same time, the perception of plan instability triggered by a small number of high-profile bankruptcies may be prompting more retirees to take their benefits as a lump sum, an option that only became widely available in the late 1990s.[33] These trends in the administration of DB plans reflect an overall shifting of responsibility for ensuring retirement security from employers to individuals.

The risk shift also manifests itself in low DC participation rates, particularly among lower-income workers, which compounds the problems posed by vast numbers of employees not being offered a plan at all. The decision to participate in a DC plan, like all the accompanying investment decisions, is typically one that the worker must proactively make. Unlike with pensions, where workers who meet a minimum tenure requirement are assured the benefit without having to sign up, employees must generally take the initiative to enroll in a 401(k). If the default option is non-participation, many workers who feel unsure if they earn enough to save will be unlikely to commit. In March 2008, the take-up rate among workers whose employers offered a DB plan was 96%; for DC plans, only 77% participated.[34] Recent reforms that support automatic enrollment for DC plans (discussed in more detail below) have begun to address this imbalance.

Gaps in access and participation reveal significant disparities among workers based on race and income. Around 69% of white private sector employees have access to a workplace retirement plan, compared to 62% of black workers and 43% of Latinos.[35] Consequently, only 55% of white workers, 48% of black workers and 32% of Latino workers actually participate in a plan.[36] While some may save independently, many are not saving at all, greatly increasing the likelihood that they will experience economic insecurity during their years after they leave the workforce.

Furthermore, these disparities are often exacerbated rather than mitigated by Social Security benefits, despite the program's relatively progressive structure.[37] For decades, Social Security has been a critical lifeline for many older Americans. Currently, around 10% of seniors live below the poverty line; without Social Security, this figure would jump to almost half of retirees.[38] However, Social Security is not and was never intended to be an adequate income replacement on its own. The average benefit is just shy of $15,000 a year.[39] Because of lower lifetime earnings, black and Latino retirees receive 26 percent less in average annual Social Security benefits than do whites.[40] Yet over 30 percent of blacks and 26 percent of Latinos, compared to 22 percent of whites, rely on Social Security for more than 90 percent of income in retirement.[41]

Finally, beyond low participation, a system that places the burden of managing retirement security entirely onto

[33] Ghilarducci (2008).

[34] Bureau of Labor Statistics (March 2008). `
[35] Rhee (February 2012).
[36] Rhee (February 2012).
[37] Favreault and Mermin (2008).
[38] Van de Water and Sherman (2012).
[39] Social Security Administration.
[40] Rhee (February 2012).
[41] Rhee (February 2012). Among all workers over 80, 76% rely exclusively on Social Security for their income. Center on Budget and Policy Priorities, Policy Basics: Top Ten Facts about Social Security.

individual workers poses a variety of other barriers to the long-term financial security of the workforce. Research has shown that many people determining their own retirement contributions underestimate how much they need to save or how long they will live, and thus end up accumulating less than necessary.[42] Furthermore, in practice, workers with DB plans are likely to accumulate more than their counterparts with the same work history in DC plans, due in part to the high level of "leakage," or early withdrawals, from 401(k)s.[43] Lastly, due to their percentage-based match structures, DC plans inevitably provide much higher benefits to higher paid workers. A 5% match for an employee making $25,000, for example, is $1250; for a worker making $100,000, it's four times as much. This regressive benefit structure compounds inequitable plan access among workers who are otherwise similarly situated. Public policy and tax incentives have contributed to the creation of this system by establishing a regulatory environment more favorable to DC plans than traditional pensions. Now, policy must evolve further to address the looming retirement crisis.

Automation offers a potentially constructive response. Retirement plan features that draw upon principles of behavioral economics to make it easier to save have shown promise in reducing the current system's gaps and shortfalls. Perhaps the most successful of these is automatic enrollment, through which participating employers automatically sign up all of their workers for their retirement plan unless employees choose to opt out. By changing the default, auto-enrollment has been found to significantly increase participation in retirement plans.[44] Moreover, a recent study found that the policy can have a particularly meaningful impact for lower-income workers, who are less likely than higher earners to be "active savers" who alter their investment decisions in response to changes in retirement policy.[45]

[42] Ghilarducci (2008).
[43] Ghilarducci (2008), p. 77-79.
[44]GAO (2009) ; *see also* Madrian and Shea (2001).
[45] Chetty et al. (2012).

Indeed, auto-enrollment has been shown to reduce both income and racial disparities.[46] For example, a 2012 study found that black workers who were not subject to auto-enrollment participated in plans at a rate of 64% in 2010, while Latinos participated at 59%; among whites, the participation rate was much higher, at 77%. However, employers who offered auto-enrollment reported both higher participation and a much narrower racial gap: their black employees participated at 82%, Latinos at 83%, and whites at 85%. The Pension Protection Act of 2006 made it easier for employers to adopt auto-enrollment, and recent studies show that an increasing number of workplaces are doing so.[47] The growing popularity of this policy could have a significant impact in promoting retirement savings equity.

Auto-enrollment has been shown to boost participation and to reduce both income and racial disparities.

However, while auto-enrollment has been highly effective in boosting participation, its effects on overall saving are mixed. Default contribution rates are often set as low as one or two percent, which makes it difficult for workers to save adequately for retirement even with an employer match. Many financial advisors recommend contributing no less than six percent of each paycheck to achieve sufficient income replacement by retirement. Boosting default contributions to these levels would increase the potential for workers to accumulate an adequate balance. Additionally, automatic escalation, which typically increases a worker's contribution automatically each year or with each pay raise, helps employees increase the amount they save without even thinking about it. These types of "nudge" policies can enable workers to overcome the inertia that often poses a barrier to saving, while simultaneously

[46] GAO (2009); Choi et al. (2001); Ariel/Aon Hewitt (2012).
[47] Brown (2010).

reducing the participation and savings gaps in the retirement system at large.

Retirement (In)security in California

As the most populous state in the nation, and with a particularly high proportion of low-wage workers, California faces some unique and critical retirement challenges. In California, 6.3 million private sector workers lack access to a workplace retirement plan, and in recent years coverage has been trending down. From 2008 to 2010, only 45% of California's private sector workers between 25 and 64 years old had access to a plan; this is a decrease from 50% from 1998 to 2000. Additionally, only 37% of the state's private workers actually participate in a plan, reflecting a persistent gap between those who are eligible for a plan and those who are enrolled.[48]

In California, 6.3 million private sector workers lack access to a workplace retirement plan.

In California, as in most states, the groups that are at the greatest risk of retirement insecurity are low-income workers, workers of color, women, and workers at small employers.[49] Members of these groups are typically far less likely to have access to a workplace retirement plan (and for women, far less likely to accumulate sufficient earnings due to the gender wage gap and fewer average years in the workforce). The median annual income of workers who do not have access to a plan is $26,000, which equates to half the earnings of those who do. Only 22.1% of the bottom income quartile has access to a plan, compared to 68.5% in the top quartile.

Similarly, just a third of Latino workers in the private sector have access to retirement plans, which is a far lower proportion than other racial groups.[50] This is explained in part by the fact that California's Latino workforce is disproportionately concentrated in low-wage sectors such as construction, food service, and accommodations. Finally, two-thirds of the private sector workers in California without access to a plan are at firms of 100 or fewer employees.

Retirees without personal savings are much more likely to rely on the social safety net or financial support from their adult children to meet basic needs and expenses.

Inadequate retirement savings can have a devastating impact on both individual households and the larger economy. Currently, 47% of California workers are expected to retire with incomes below 200% of the federal poverty level (FPL), or about $22,000 a year.[51] The outlook is even worse for younger workers; recent projections estimate that 55% of those between the ages of 25 and 44 will fall below the 200% FPL threshold. As traditional DB pensions disappear, retirees without personal savings are much more likely to rely on the social safety net or financial support from their adult children to meet basic needs and expenses. Widespread retirement insecurity thus imposes a cost on both families and society. Establishing broader and more equitable access to retirement savings opportunities can enable seniors to retire at a reasonable age, remain self-sufficient, and maintain their quality of life when their time in the workforce is over.

The California Secure Choice Retirement Savings Program

California has taken a significant step in acknowledging its retirement crisis and striving to craft a response through the passage of SB 1234, a bill sponsored by Sen. Kevin de

48 Rhee (June 2012).
49 Rhee (June 2012).
50 Rhee (February 2012).
51 Rhee (June 2012).

León and Sen. Darrell Steinberg that will create the California Secure Choice Retirement Savings Program. Signed into law in September 2012, the Act will create a retirement savings program administered by the state for private sector workers who do not have access to accounts through their employers. The program is intended to be a sustainable, self-funding path to retirement security for California's workers. Employees' payroll contributions will be pooled into a trust, which the nine-member California Secure Choice Retirement Saving Investment Board will administer.[52] The Board, with appointments from the Governor, the Senate Committee on Rules, and the Speaker of the Assembly, will select an investment manager to invest the funds to provide a stable and low-risk rate of return. These accounts are designed to act as a crucial supplement to Social Security benefits, with the goal of achieving a "minimum wage" of retirement income for Californians. While final authority on program rules and policies will be the responsibility of the board, the legislation identifies a number of key features of the program, which are described below.

Auto-Enrollment

One of the central features of the program is that it automatically enrolls all eligible employees, who are defined as private sector workers at firms of five or more employees that do not offer their own retirement accounts. Employees can opt out of the program if they choose and can withdraw any contributions without facing a penalty for the first ninety days. After that, withdrawing the contributions would incur a fee, but employees would always have the option of maintaining their account but stopping the payroll deduction. Prior to enrollment, employees will receive an information packet and disclosure forms specifying the risks and benefits of participation, instructions for opting out, and information about withdrawing funds.[53]

At least every two years, employers will designate open enrollment periods during which employees who had previously opted out can sign up for the plan. Additionally, the bill stipulates that the Investment Board will have the authority to evaluate and establish a process whereby employees of non-participating employers can enroll in the program.[54] Given auto-enrollment's proven success at increasing retirement plan participation, this feature should enable the program to reach a broad swath of the target population in an effective and efficient manner. It is the mechanism by which California will extend participation in a savings plan to up to six million additional people, at essentially no cost to the public purse.

These accounts are designed to act as a crucial supplement to Social Security benefits, with the goal of achieving a "minimum wage" of retirement income for Californians.

Contribution Structure

The CSC proposes a default employee contribution of 3% of income, which will flow to the trust through a payroll deduction. Workers can decide to adjust their contribution rates or withhold contributions at any time. The Investment Board has the authority to shift the default rate between 2% and 4% and may elect to set different rates within this range for different employees, based on how long the worker has been participating in the program.[55] Because the accounts will be treated as tax-preferred Individual Retirement Accounts (IRAs), workers will be subject to the IRA contribution limits established by the Internal Revenue Service.[56]

[52] SB 1234 provided for a seven-member board, but the subsequent companion legislation, SB 923, will expand the board to nine when SB 1234 is enacted.
[53] The California Secure Choice Retirement Act, Title 21, Sec. 100014.
[54] The California Secure Choice Retirement Act, Title 21, Sec. 100012 (l).
[55] The California Secure Choice Retirement Act, Title 21, Sec 100032(i).
[56] The California Secure Choice Retirement Act, Title 21, Sec 100008(a); 100010(a)(11); 100043.

Currently, the program does not provide for an employer match because so doing would cause the accounts to come under the purview of the Employee Retirement Income Security Act ("ERISA"), the federal statute governing employee benefits that preempts state laws. Nevertheless, the bill gives the Investment Board the authority to allow employer contributions should there become a way to do so without triggering ERISA and/or violating other rules in the current tax code.[57]

Portability

The lack of portability in a typical retirement plan (i.e., its connection to a single employer) poses a barrier to continuous saving and is a key driver of "leakage" in the retirement savings system.[58] Too often, workers leaving a particular job cash out their 401(k)s and end up starting from scratch in a new position; many plans actually require workers to withdraw their funds when they leave a position if their balance is below a designated minimum.[59] In other cases, retirement accounts get "lost" when a worker changes employers, resulting in millions in unclaimed benefits every year.

> The lack of portability in a typical retirement plan poses a barrier to continuous saving and is a key driver of "leakage" in the retirement savings system.

The CSC addresses these problems by linking the accounts to the worker rather than to the employer, and keeping accounts open as workers move from one job to the next with no need to roll over balances. Through centralized recordkeeping and investment management, the accounts are designed to be easier for workers to keep track of and maintain during a career move.

Pooled Investments

The CSC relies on a pooled investment structure to leverage economies of scale, reduce insurance and management costs, and increase efficiency. The Investment Board will contract out investment management responsibilities through a bidding process, and the investment manager will be tasked with adhering to the plan investment policy of preserving the principle and providing a safe, stable rate of return.[60] The investment manager collectively invests workers' contributions in a conservative portfolio and individual account balances are determined by each worker's deposits and the annually determined interest rate. The pooled investment structure and professional management are a means to mitigate the risks inherent in individual retirement accounts, such as currently available IRAs and 401(k)s.

Guaranteed Benefits

A unique feature of the California program, which distinguishes it from both private plans and many other universal account proposals, is its provision of a guaranteed return. With a traditional 401(k) plan, a worker assumes all the risk for the vagaries of the market. Contributions to these saving plans can increase in value if the market goes up or they can drop in value if the market goes down. California's approach is committed to creating protections against the declines while still offering the potential for market gains. The California statute sets in motion a process to protect and insure the value of workers' accounts. This may be accomplished through the purchase of secure investments, such as U.S. Treasuries, as well as private insurance. While private insurance makes the plans more expensive to administer (with a cost that rises steeply with the guaranteed rate of return), relying on private insurance is designed to alleviate fears that the state could

[57] The California Secure Choice Retirement Act, Title 21, Sec. 100012(k).
[58] Calabrese (2011).
[59] Rhee (June 2012).

[60] CalPERS, the California Public Employees' Retirement System, is therefore authorized to bid, and many have speculated that they will take on the investment management role.

be liable should the fund underperform due to economic conditions.

The plan as envisioned should create no new costs for the state and should in fact strengthen overall economic security by providing millions of Californians with a critical supplement to their Social Security income.

Currently, the bill does not provide a specific rate of return, which is something that would be determined annually by the Investment Board for the following year. However, the law does stipulate that equities can account for no more than half of the overall asset allocation of the investment funds. Recent projections estimate that a hypothetical conservative portfolio (50% equities/50% bonds or treasuries) for a publicly sponsored retirement fund is likely to generate a 5% real rate of return over the long-term.[61] While the costs of private insurance will reduce this figure, economic models still predict that workers will see a modest return on their investments absent exceptionally poor economic circumstances, and that therefore a guarantee of a 2 to 3% real annual rate of return would be a reasonable expectation. In addition, the CSC trust has the authority to maintain a reserve account to which it may allocate excess earnings to protect against future losses.

Self-Financing

Finally, an important aspect of the CSC is that it is designed to be self-financing. The money that account holders contribute to the trust is divided into two accounts: an administrative fund and a program fund. Administrative expenditures derive entirely from workers' contributions, although the costs of administration cannot exceed 1% of the total fund each year.[62] According to recent estimates, a state-sponsored plan with a modest minimum return guarantee (3% nominal) would be fully funded or over-funded for the first forty years.[63] Additionally, the plan should impose no new costs on employers; their only obligations are: 1) the ministerial duty of providing employees with the information packet, and 2) adding a field to their payroll, similar to the existing fields for tax deductions, to enable employees to remit contributions to their account. Therefore, the plan as envisioned should create no new costs for the state and should in fact strengthen overall economic security by providing millions of Californians with a critical supplement to their Social Security income.

[61] Stubbs and Rhee (2012).

Next Steps for California Secure Choice

When Governor Jerry Brown signed SB 1234 into law, he initiated a process that could lead to the implementation of the first state-sponsored retirement plan for private sector workers. A number of steps need to be taken and key questions addressed concerning the default plan features, funding, and product design before the California Secure Choice Retirement Savings Program launches. Moreover, the dialogue surrounding the program presents an opportunity for discussion and enactment of broader structural reforms to address some of the barriers beyond account access that impede low-income workers' ability to save adequately for retirement. In this section, we explore the next steps for implementing the California initiative; pose some additional questions regarding the design of the program and its savings products; and assess how the larger retirement savings landscape is (or is not) responding to the needs of low-income workers and their families.

Forming the Board

Now that California has cleared the preliminary political hurdles to the implementation of SB 1234, it must turn to

[62] The California Secure Choice Retirement Act, Title 21, Sec 10004(d).

[63] Stubbs and Rhee(2012).

the mechanics and additional research essential to the program's launch and sustainable success. The first two necessary steps are to designate the members of the Investment Board and to raise funds from private and non-profit groups to conduct a market analysis.

The program presents an opportunity for discussion of broader structural reforms to address some of the barriers beyond account access that impede low-income workers' ability to save adequately for retirement.

As previously noted, the Investment Board will consist of nine members, including four gubernatorial appointees. In addition to the Treasurer, the Director of Finance, and the Controller, the Board will include a small business representative, an employee representative, and an individual with retirement savings and investment expertise, along with a member of the public and two additional members.[64] While the bill does not require that all Board members be permanent residents of California, all are expected to have at least a close connection with the state. The bill's sponsors anticipate that the composition of the Board will be finalized by late spring of 2013.

Conducting the Market Analysis

Once the Board is established, it will convene to determine the scope and parameters of the market analysis. Broadly speaking, the market analysis will evaluate likely participation rates, investment product design, contribution levels, and other variables that will affect the feasibility and mechanics of implementation. The results of this analysis, which is slated to be complete by mid-2014, will allow the Investment Board to determine whether the bill as written would indeed create a self-sustaining fund.

However, an initial obstacle to overcome is securing funding for this study. Cost estimates for the market analysis range from $500,000 to $1.5 million. All of these resources must come from private or non-profit entities. Ideally, from the perspective of the bill's sponsors, the funders of the study would represent a diverse spectrum of sectors and interests to signal broad support for the program.

Furthermore, before it can open for enrollment, the CSC must gain approval from the U.S. Department of Labor clarifying its relationship to ERISA, as well as a confirmation from the Treasury Department regarding the plan's tax-qualified status. Lastly, as established by the companion bill, SB 923, the program requires an authorizing statute from the legislature before workers can participate. Given the many details yet to be finalized by the Investment Board, the authorizing statute could contain some amendments to the original bill.

Program Design Considerations

The initiative in California has the potential to serve as a model for similar public retirement programs throughout the country. It is particularly important, therefore, that the market analysis and the ongoing policy development process address a range of considerations regarding defaults, account options, and distribution of benefits that will be key for making the program work most effectively for low-income workers.

Default Contributions

As previously discussed, default enrollment and contribution policies have been found to have significant impacts on retirement plan access and participation. Because these policies have been so effective, however, it is important that the defaults are set at optimal levels. Two-thirds of employers with automatic enrollment set the default rate at 3%, as would the California plan, though there is growing evidence that this contribution level falls short of what many employees would choose for

[64] S.B. 923.

themselves.[65] Moreover, research suggests that these low defaults can make it more difficult for workers to save adequately. For example, a recent study found that automatic rates of 3% resulted in an average savings rate of 6.3%, while a 6% default yielded savings of 7.1%.[66] Additionally, employees in the 6% default group were twice as likely as those in the 3% group to attain an overall savings rate of 11%, which many financial planners recommend as the ideal retirement savings threshold.[67]

The same inertia that explains the success of automatic enrollment and contribution policies can render them counterproductive if the defaults are insufficient.

Furthermore, the same inertia that explains the success of such default policies can render them counterproductive if the defaults are insufficient. In particular, plans that do not include a mechanism such as automatic escalation for gradually increasing an employee's contributions can lull workers into making inadequate contributions over time. For example, younger workers could benefit from a "nudge" to increase their savings rate as their earnings increase. Two recent surveys found that workers generally support both automatic saving and pre-determined increases in savings amounts.[68] In the 2009 study, even 90% of those workers who had chosen to opt-out of the plan reported feeling satisfied with the automatic enrollment mechanism and procedure.[69]

A straightforward way to address this issue would be to increase the default contribution. However, this solution could place a significant burden on workers at the lower end of the income spectrum and potentially discourage initial participation. Another option would be to default employees into automatic escalation and require an opt-out, as with the overall plan.[70] Presuming most workers' earnings increase over time, this approach would allow workers to gradually save more without coping with a sudden or overly burdensome decrease in liquidity. Finally, regardless of the automatic contribution rate, participating employees could receive information regarding recommended levels of contributions as compared to the default, since they can elect to contribute in excess of the 2 to 4% automatic range. This information could include charts demonstrating how 3% contributions would grow over thirty years at a range of salaries compared to 6% contributions, for example. An assessment of these and other options, as well as the projected outcomes of various default mechanisms, would be a highly useful piece of the market analysis, both for California and for other states considering similar programs.

Employer Contributions

For many workers, an employer match or contribution is often a key motivating factor in the decision to participate in a retirement plan.[71] Employer contributions enable workers to accumulate significantly higher account balances and constitute an important part of a competitive compensation package. While many firms cut contributions to their employees' accounts during the most recent recession, the numbers have since bounced back, with approximately three-quarters of employers who offer plans also providing a match.[72] Establishing an employer contribution as a standard part of a retirement plan would help recalibrate retirement security as a shared rather than strictly individual responsibility, despite the rapid decline in traditional pensions.

[65] Tergeson (2011).
[66] Principal Financial Group (2011).
[67] Principal Financial Group (2011); John Testimony (2011).
[68] John Testimony (2011). The surveys were: Prudential, The New Economic Reality and the Workplace Retirement Plan, January 2010; and Retirement Made Simpler, How do employees feel about their auto 401(k) plan?, 2007.
[69] Prudential (2010).
[70] Calabrese (2011).
[71] Dworak-Fisher (2008).
[72] Javis (2012).

Since the CSC could potentially reach over six million households, facilitating employer contributions would be a powerful feature that would make the program much more impactful, and set a precedent for future state-sponsored retirement plans. The obstacle is that employers cannot make tax-deductible contributions to a pension or retirement saving plan unless it is a "qualified plan" under ERISA and subject to certain non-discrimination rules and other restrictions. Currently, as a program limited to facilitating employee saving, CSC appears to fall within ERISA's "safe harbor" provision, which excludes a plan from the ERISA definition as long as: 1) employers cannot contribute to the plan; 2) employers do not exercise control over the plan, but limit their role to collecting and forwarding payroll deductions to the IRA plan sponsor; and 3) employees' participation is voluntary.[73] If California instead structured the CSC to accept employer contributions on a tax-preferred basis, as qualified plans do, it would no longer qualify for the "safe harbor" exemption from ERISA rules and California would no longer have the authority to implement the program according to the terms of its own legislation.[74] While there are some concerns that the CSC not undermine the participation of employers currently sponsoring DC plans, the main reasons that the legislation opted for an ERISA-exempt approach was to avoid adding reporting requirements and fiduciary responsibilities to employers not offering plans.

[73] 29 C.F.R. 2510.3-2(d); *see* Department of Labor, Interpretive Bulletin 99-1, "Payroll Deduction Programs for Individual Retirement Accounts, 29 C.F.R. 2509, at p. 33001, which states: ". . . the Department has published a regulation at 29 CFR 2510.3-2(d), establishing a safe harbor under which an IRA established by employees and funded through payroll deductions will not be considered to be a "pension plan" within the meaning of section 3(2) of Title I when the conditions of the regulation are satisfied. The regulation specifies that an IRA will not be considered a "pension plan" when there are no contributions made by an employer; employees participate in the IRA on a completely voluntary basis; and the employer's activities with respect to the IRA must be limited solely to permitting, without endorsement, the IRA sponsor to publicize its program to employees; collecting contributions through payroll deductions or dues checkoffs; and remitting those contributions to the IRA sponsor.".

[74] The California Secure Choice Retirement Act, Title 21, Sec 100043.

As a growing number of states begin to explore the possibility of implementing a program like California's, this issue will become increasingly important. The market analysis process in California presents an opportunity to determine what sort of federal action, such as an amendment or a regulatory change by the Department of Labor, would be required to enable tax-deductible employer contributions to publicly introduced plans.

Employer contributions enable workers to accumulate significantly higher account balances and constitute an important part of a competitive compensation package.

Product Design and Investment Allocation

The California program poses some important questions regarding the design of the accounts themselves and investment allocation. Many of these questions concern the manner in which the guaranteed rate of return is implemented, which is one of the most unique features of this policy effort. The guaranteed rate of return makes the CSC similar to a cash balance plan, which is a DB scheme in which employees' account balances are based on their contributions rather than their earnings and years of service, and in return workers are assured an annual credit equal to a specified percentage of the balance. However, the CSC's reliance on private insurance (rather than the federally-backed Pension Benefit Guaranty Corporation) and an independent investment manager (rather than the employers themselves) are important distinctions. Furthermore, true cash balance plans, because they are pension plans sponsored by employers, are subject to ERISA.

The private insurance component is closely linked to the guaranteed return. As the rate of return increases, the costs of insurance are likely to rise as well. On the one hand, the insurance mechanism all but eliminates any risk for employees participating in the program. At the same time, if it is too expensive, it may pose a barrier to helping workers accumulate significant savings.

One refinement might be to limit the insurance guarantee to workers who are close to retirement age (e.g., 55 and older) since market volatility poses the greatest risk to older workers whose asset balance may not recover from a steep downturn by the time they stop working. This is particularly relevant for a program, like the CSC, which may encourage annuitization as the preferred method of payment distribution. Since the worker's monthly payments for life are typically based on the account balance at retirement, without insurance a market downturn within the years immediately prior to retirement could lock in a permanent loss of lifetime income. In contrast, a younger worker may have decades to recover from what historically have been temporary market downturns (since, on average over ten-year periods, both U.S. stock and bond markets have historically had positive returns that revert to the mean given sufficient time).

Another idea to explore during the market analysis would be the possibility of providing multiple fund options while maintaining the guaranteed return option as the default. The Thrift Savings Program (TSP), the retirement savings program for federal employees, provides a useful point of comparison. Participants in the TSP can choose among a variety of funds, ranging from the "G" Fund, which invests solely in government securities and guarantees the principal, to the "I" Fund, which invests in a range of international stocks and carries the greatest degree of risk.[75] Average annual returns for the G Fund have been 3.6% over the previous ten years, compared to 8.4% in the I Fund. Adopting a similar structure in the California program or other public retirement plans would give workers the option of potentially increasing their returns or better matching their risk-reward profiles; however, the provision of these options would need to be accompanied by adequate information and education regarding the varying levels of risk that come from increased market exposure.

There are also questions about the distribution of the benefits. The California bill does not currently require annuitization, though there is flexibility to establish it as another default option that would go into effect as a recommended behavior unless the individual affirmatively opts out.[76] As discussed in the final section, however, mandatory annuitization carries its own risks at a time when a substantial proportion of American families have insufficient savings for shorter-term needs. An alternative approach would be to default some proportion of each worker's account into an annuity rather than the entire balance.[77]

Low Access Workers

Finally, although the California initiative and other state-sponsored retirement savings programs enable the vast majority of private employees to qualify for the plan, some are left out. In particular, workers employed by the smallest firms, as well as those who are self-employed, may have more difficulty accessing these programs because their workplaces are not required to participate.[78] Importantly, the group most likely to be self-employed is men aged 55-64, who are rapidly nearing retirement.[79]

In California, automatic enrollment will be restricted to workers at employers of five or more, while similar plans emerging in other states set the minimum threshold at ten. The California bill provides the Investment Board with the authority to develop procedures for enrolling these workers.[80] Once these policies are in place, assessing how to educate these workers about their eligibility for the plan and the benefits of participation will be of particular

[75] Thrift Savings Plan, Fund Comparison Matrix.

[76] Calabrese (2011).
[77] Hamacher and Pozen (2011).
[78] *See* Calabrese (2011) for a discussion of how inadequate access by self-employed, part-time and small firm workers is a recurring issue in Auto-IRA proposals.
[79] Schultz (2012).
[80] The California Secure Choice Retirement Act, Title 21, Sec 100012 (l).

importance, since they will not benefit from the same default enrollment mechanism as employees at larger firms.

Further Policy Considerations

California Secure Choice poses questions and considerations that reveal larger shortcomings in the retirement savings system. Indeed, savings policy experts have long criticized the current landscape of federal retirement policy for its "upside down" structure.[81] Current federal supports for retirement savings, which are delivered almost exclusively through the tax code, disproportionately benefit higher income families, in part because these families fall into higher tax brackets and have more to gain from the deduction. In 2011, for example, 80% of the tax benefits from 401(k)s and other qualified plans went to households in the top income quintile.[82]

> Current federal supports for retirement savings, which are delivered almost exclusively through the tax code, disproportionately benefit higher income families.

Federal expenditures for other asset-building purposes also tend to accrue primarily to wealthier households.[83] Additionally, few low-income families have a sufficient savings cushion to cope with an emergency, job loss or unexpected expense. As a result, even those households with retirement accounts often dip into them to cover shorter-term costs, thus undermining the benefits of such policies as automatic enrollment. In this section, we briefly examine these larger structural issues and two potential policy responses: the Financial Security Credit and workplace savings accounts for purposes other than retirement.

Financial Security Credit

The Financial Security Credit is a proposal to provide a match of up to $500 per year to families earning below around $58,000 (or 120% of the EITC income maximum) who make a deposit to qualifying saving instruments, including retirement accounts.[84] The Financial Security Credit would be a significant step toward disrupting the retirement system's "upside down" incentives and benefits. The Credit would also allow tax filers to make a deposit to a newly created account directly on their tax form.

> The Financial Security Credit would complement proposals like the CSC both by promoting higher savings rates and providing the flexibility to save for other purposes.

The Financial Security Credit would complement proposals like the CSC both by promoting higher savings rates and providing the flexibility to save for other purposes. Unlike the existing Saver's Credit, the Financial Security Credit would be refundable, thus giving filers without sufficient income to incur tax liability an incentive to save. This incentive would trigger additional contributions and increase savings adequacy. At the same time, it would provide workers who are not receiving contributions from their employers the option to nevertheless earn a match to their own contributions. Moreover, the Financial Security Credit would allow families to choose from a range of different savings products that would best meet their needs, such as IRAs, college savings accounts, and savings bonds. As the debate regarding tax reform intensifies, initiatives like the Financial Security Credit present an opportunity for

[81] Assets Report 2012; Calabrese Testimony (2012).
[82] Toder and Smith (2011).
[83] Cramer et al. (2012).
[84] "The Financial Security Credit" (2012).

furthering equity in the tax code at a relatively minimal cost.[85]

Promoting Workplace Emergency Savings

One of the strengths of the Financial Security Credit is that it reflects the reality that families have multiple and varied savings needs and goals. Though putting aside money for retirement is crucial, it is but one component of the overall savings framework that can enable families to experience financial security both in the present and in the future. Because of its existing payroll structure, the workplace has potential to serve as a site for some of these savings opportunities that extend beyond retirement, which are worth exploring in tandem with programs like the CSC.

> An insufficient emergency fund "has the strongest association with the likelihood that workers will breach their retirement savings."

Recent research has shown that a high proportion of low and moderate income workers are cashing out their retirement plans to pay for everyday expenses.[86] In 2010, Americans took out $70 billion in early withdrawals from their retirement accounts, compared to $118 billion in worker contributions.[87] These early withdrawals are typically subject to both a federal tax penalty of 10% as well as the income tax, meaning that an unreasonably high proportion of workers who contribute to a 401(k) are ultimately losing money. Regardless of whether a given plan automatically enrolls workers or permits employer contributions, if workers are typically using them for short-term savings needs, access to these accounts will do little to bolster retirement security and reduce inequities.

One proposal that could reduce these so-called "breaches" of retirement accounts is increasing the availability of other workplace savings opportunities and workplace emergency loans. Indeed, an insufficient emergency fund "has the strongest association with the likelihood that workers will breach their retirement savings."[88] A workplace lending program could reduce this phenomenon and also provide an alternative to payday loans, which frequently have exorbitant interest rates that trap borrowers in a cycle of debt. Similarly, workplace programs that provide opportunities to save for emergencies or shorter-term goals could take advantage of the same payroll deduction infrastructure as retirement contributions while increasing the likelihood that workers' retirement savings are actually available at retirement. In the U.K., "corporate platform" accounts do just that, by automatically enrolling workers in a retirement savings program that also gives them the option to save for other purposes, with the added benefit of a financial education component.[89]

Alternatively, and as previously noted, one obvious solution to account "breaches" is to make accounts inaccessible to beneficiaries until retirement and to require annuitization, as with traditional pensions. Yet without access to liquid savings that can address more immediate needs and changes of circumstance, many workers may feel understandably reluctant to lock away their savings for the future at the cost of increasing their financial vulnerability in the present. Creating mechanisms for this type of saving, either as a fund option within a program like California's or as part of an independent initiative, would reflect an essential recognition that low-income families have a range of savings needs and that incentivizing retirement savings alone can backfire.

A Model for Reform

It has become clear that the current retirement savings system is not working— especially for lower-income workers. The California Secure Choice Retirement Savings Program shows promise as an innovative effort to connect more workers with retirement savings opportunities, at a

85 "The Financial Security Credit" (2012).
86 Fletcher (2013).
87 Fletcher (2013).
88 Fellowes and Willemin (2012).
89 John (2012).

minimal cost to the public. Significant work remains for the initiative in determining the ideal program design features, including defaults and account options.

Nevertheless, the program has the potential to serve as a strong national model for a new approach to retirement security—and momentum for this effort is growing. Many states, including Illinois, Maryland, Connecticut, and Massachusetts, are already considering similar proposals. In order to continue to support retirement security as a shared rather than solely individual responsibility, these parallel efforts will need to engage with the issue of how to enable employer contributions. Furthermore, as this movement continues, it will be important for advocates and policymakers to keep in mind both the short- and long-term savings needs of low-income families.

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